IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees.

No. 2813

APPELLANTS' REPLY BRIEF.

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By.., Deputy Clerk.

The James H. Barry Co.,
San Francisco

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Preliminary Statement.

We think that counsels' minute and somewhat highly critical analysis of the facts respecting appellants'

claims of preference, do not materially alter the clear meaning and effect of the Agreed Statements upon which the two cases were tried. There is no avoiding the issue that the principal question for determination upon this appeal and which respective counsel in drafting the Stipulations of Facts attempted to present, is whether the material and supplies furnished to the Railway Company, when taken in connection with the extent and value of its properties, and of the subsequent diversion to the use of the bondholders of the earnings from which it was expected that payment would be made, may reasonably be considered to be of the character for which preference may equitably be granted.

Counsels' construction of the Agreed Statements of Facts in respect to the claims of both appellants would seem to convert them into meaningless stipulations. The argument that the supplies or materials furnished cannot be considered in relation to the whole system of which they form a part, but only in connection with the particular branch in which they were used, departs from the rule of the decisions and from clear effect of the admitted facts.

Counsel for appellees also earnestly contend for the rule, that where preference is claimed by reason of the wrongful diversion of funds, only that income can be considered which was earned *after* the debt had matured; and further, that it is necessary to show, not only that the claimant, but also the railway com-

pany, expected payment from current income. These contentions, if sound, would practically defeat all claims of preference and destroy the doctrine which equity has established and carefully guarded. We earnestly ask the Court's attention to a brief consideration of the soundness of these views.

Without entering upon a detailed reply to all the various topics discussed by counsel, as above outlined, it would seem sufficient to observe that there are two main considerations which distinguish the authorities upon which appellees rely, and which distinctions are recognized in the cases themselves. These are: First. The authorities which counsel urge impose such rigid restrictions upon preferential claims are, we think, *without exception cases in which there was no diversion of income,* but where it is sought to charge the corpus of the estate with the payment of the claims, which to that extent would displace the mortgage lien. Such cases therefore have little application here. And, second. The material and supplies furnished by appellants is treated only in the relation, or *mathematical percentage,* which it bears to the Gem Transmission Line in the one case, and the Swan Falls plant in the other, almost infinitesimal portions of the comprehensive and admittedly interdependent system of properties belonging to the Railway Company, instead of its relation, as in all other cases, to the system itself.

BASIS OF APPELLANTS' CLAIMS.

The whole doctrine of equitable preference is found expressed in the language of the Supreme Court in *Fosdick* v. *Schall,* and repeatedly in later cases, that

> "the power rests upon the fact that in the administration of the affairs of the company the mortgage creditors *have gotten possession of that which in equity belongs to the whole, or a part of the general creditors.* Whatever is done therefore, must be with the view *to a restoration by the mortgage creditors of that which they have thus inequitably obtained.*"

Were appellants seeking to take from the mortgage creditors something upon which the latter had a prior lien, we must confess there would be greater force in counsels' argument, but we are not attempting that. We are only trying to get back what *they* have taken. It is not necessary here to dispute their authorities. The claims of preference here are based chiefly upon the *wrongful diversion of the income and earnings intended and available for the payment of these claims,* upon which the bondholder had no lien and which were diverted, after these obligations were incurred, to the payment of interest on the mortgage. Upon this question of diversion of income, admittedly the chief reliance of appellants, the brief of counsel is practically silent.

The mortgagee has no lien upon the current income

until reduced to possession through the appointment of the Receiver. This is elementary. Before that time the current income was available for current needs. This rule was recognized by Judge Dietrich in this case, as explained by counsel for appellees, by refusing to impound for the benefit of the bondholders any of the income received, or collections made, prior to the date of filing the suit in foreclosure, December, 1914. But if the money which was diverted and paid in interest on June 1, 1913, had not been so paid, it would have then remained a part of the fund available under this decree for creditors' claim. It was held by the Court below that the bondholder was not entitled to any of the earnings or collections prior to the date of his suit. Then why is he entitled to retain the sum so wrongfully diverted? He had no lien upon it until reduced to possession through the institution of foreclosure proceedings and the appointment of receiver. The bondholder, however, has the money, which was paid on June 1st, *from the earnings of the corporation because,* having practical control of the Railway Company and being "with respect to finances, its managing director," *he took it,* notwithstanding the fact that the claims for material and supplies which it is agreed *were necessary to the continued maintenance and operation* of the various properties, were left unpaid.

THE EQUITIES OF THE CLAIMS.

The manager, or head of the syndicate owning the bonds was the managing director of the Railway Company with respect to its finances (Tr., p. 118). *As the purchasing order came from New York, there is no escape from the conclusion that it came from this managing director who was also in control of the bondholders' syndicate. The material "has become a part " of the Railway Company's system, has enlarged the " same and has contributed to the earnings and to the " value of the properties and to the security of the " bonds"* (Tr., pp. 49 and 72). *It is a part of the property which was sold under decree of foreclosure. In April and June of 1913, after the obligations had been incurred and the debts created, and "while the material was being supplied," the corporation had accumulated and had on hand $115,550 derived solely from earnings and available for paying these claims. "It was intended and agreed between the parties that the sale should be a cash transaction"* (Tr., p. 42). *There was no other fund from which payment could be made. The claimants believed, and the Railway Company allowed them to believe, that the claims would be paid in cash out of "current operating income"* (Tr., p. 43). *The bondholder had no lien upon this $115,000 or any part of it, because not reduced to possession. Notwithstanding this, the $115,000 was diverted and paid by the bondholders*

to the bondholders, after the debts had in this manner been created or incurred. The bondholder received the benefit of the material which enhanced his security to the extent of its value, and at the same time secured and retained the earnings of the property intended for its payment. These are the circumstances, which we shall attempt to elaborate and confirm a little more in detail, under which appellants are seeking a preference or, more strictly speaking, a restoration of what the bondholder "thus inequitably obtained."

It seems that almost every argument advanced by counsel regarding the character of the material, the necessity of its use, and the extent of the Railway Company's system, is answered in direct terms by the language of the Agreed Facts. It is argued that the material was not necessary to the operation of the property, but the Stipulations admit that it was, and without it the Railway Company could not perform its duties to the public (Tr., p. 72). *It is argued that it was only necessary to the operation of the Swan Falls plant and of the branch transmission line. But the admission is, that these are parts of the whole system, and that the Railway properties consisting of an "undivisible power system," and "an undivisible railway system," are used "in connection with said power and railway properties"* (Tr., pp. 99 and 100).

THE DIVERSION OF THE INCOME.

First, with reference to the diversion of the current income. It is urged that the burden of showing such diversion is upon the claimants, and many authorities are cited. This principle, however, we concede, but reply that the wrongful diversion is clearly established by the Agreed Statement of Facts. Counsel contend, however, that claimants seeking a preference cannot complain of diversions of current income made prior to the creation of the debt. This is also strictly true, but the rule has no application here. If by this is meant, as counsel seems to contend, that it is only the income *earned after the debt became due* upon which claimant may assert an equitable lien, then we think this is an erroneous conclusion of law, but if it is intended only to mean that the debts for which the claimants herein are seeking a preference, were *incurred* after the *diversion* complained of, then it is a mistake of fact. It is not the time when the debt *matures* which controls the right of preference, but the time when it was *incurred* or the material supplied. *Foster on Federal Practice,* p. 962, says the debt must have been "incurred before the diversion."

It may be admitted that if the diversion was made before the obligation was created, the claimant could not complain, because as to him, there was no wrongful diversion. The Court will not restore to a claimant what he was never entitled to. But if when the

debt was incurred, whether due or not, there was on hand sufficient funds derived from earnings to pay the claim and from which payment was intended, and these, or the earnings subsequently accruing, are diverted to the use of the bondholder, the creditor may seek a restoration. In the Roebling claim the material was supplied between the 18th of March and the 30th of May, 1913 (Tr., p. 42). The total amount of net earnings diverted and paid to the bondholders for interest, principally on June 1st, was $115,550, which left the Railway Company without funds to pay these claims. The Agreed Statement of Facts recites that the Railway Company was setting up reserves from its earnings "during the period when said supplies were furnished" (Tr., p. 43).

In the case of the Morris Company claim the debt was contracted or created in the fall of 1912. The net earnings from the Railway Company after this debt was incurred are shown in the transcript at page 71, and would have been available for the payment of the Morris claim but for the wrongful diversion in April and June, 1913.

It is claimed, however, that a portion of the Morris claim did not become due until after the diversion of interest complained of, which may be true, but we think is immaterial. If the preferential claimant can only assert an equitable lien on the income which is earned after the debt became due, then a debt admittedly of a preferential character incurred imme-

diately before the appointment of receiver, would be defeated, while those incurred earlier in point of time would be preferred. This is made plain by the most recent decision of this Court in the case, cited by counsel, of *Moore* v. *Donahoo,* 217 Fed., 186, where Judge Dietrich, speaking for the Court, said:

> "The appellants insist upon the former standard; that is, that there can be no diversion as to any creditor until his claim becomes due. In that view, if we suppose that employes upon monthly salaries, payable upon the 10th day of each succeeding month, render services to a corporation during a given month in expectation that they will be paid out of the current income, which they help to create, and upon the 1st day of the following month such income is applied to the payment of claims for betterments, and thereupon the mortgagee commences a suit in foreclosure and procures the appointment of a receiver, it is clear that the employes are left remediless. Again, under such a rule, what relief is available for those who supply materials or perform labor during the month immediately preceding a receivership, in a case where the current revenues for that month are applied to the satisfaction of similar claims accruing during the preceding month, which have remained unpaid because of the diversion of the current revenues for that month to the discharge of interest on bonds? And, generally speaking, it would inevitably result that *claims most recently accruing,* and therefore most clearly entitled to protection, would least often

> be in a position to demand a restoration of diverted funds. It is doubtless true in actual practise that credit is extended for current supplies and for labor upon the assumption that there has been no improvident diversion of the current income in the immediate past quite as often as upon the expectation that there will be no such diversion in the immediate future."

In *Burnham* v. *Bowen,* 111 U. S., 776, the debt for which the Supreme Court decreed a preference should be granted, though contracted for, had not matured when the receiver was appointed. The Court said, p. 782:

> "When, therefore, the Court took the earnings of the receivership and applied them to the payment of the fixed charges on the railroad structures, thus increasing the security of the bondholders at the expense of the labor and supply creditors, there was such a diversion of what is denominated in *Fosdick* v. *Schall* the 'current debt fund,' as to make it proper to require the mortgagees to pay it back. So far as current expense creditors are concerned, the *Court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made.* This rule is in strict accordance with the decision in *Fosdick* v. *Schall, which we see no reason to modify in any particular.*"

The cases cited by counsel on this point, when examined carefully, do not appear to contradict this principle. In *Fordyce* v. *Kansas City Railway, etc.,* 145 Fed., 544, the Court holds that the *diversion* by the railroad company of net income, etc., "must have been made after the creation of the debt sought to be enforced as an equitable lien," which was this case. See 3d syllabus.

Also in *Kansas Loan & Trust Co.* v. *Electric Ry. Co.,* 108 Fed., 703, the Court said:

> "The creditor can only concern himself about *diversion* of the current earnings after the creation of a debt."

It is not the earnings which *accrued* but the earnings *diverted* after the creation or maturity of the debt, which the cases refer to. Any other rule would lead to the absurdity pointed out by Judge Dietrich in *Moore* v. *Donahoo,* above cited.

Counsel for appellees will readily concede that the cases upon which they chiefly rely are the *Kneeland* and *Thomas* cases, *Porter* v. *Bessemer Steel Co., Toledo* v. *Hamilton,* and *Wood* v. *Guaranty Trust Co.* (pages 14 and 15 of their brief), the *Gregg* case (p. 58), and *Spencer* v. *Taylor* (p. 61), and the other citations from the text of *High on Receivers* and *Street on Equity Practice.*

These are all cases in which there was no diversion of income and therefore no "superior equity in the

claimants." They were cases in which claimants were attempting to displace the mortgage lien and charge the corpus of the property with the payment of their claims. This fact alone seems to distinguish them from this appeal.

The cases which establish the rule of preference where there is a wrongful diversion of income and the injury of the supply creditors are *Fosdick* v. *Schall, Burnham* v. *Bowen, Southern Ry.* v. *Carnegie, Virginia and Alabama Coal Co.* v. *Central Railroad Co.,* and other cases on page 46 of our opening brief, which we will refer to later.

In the Carnegie case, 176 U. S., at p. 284, it was said:

> "In neither the Kneeland nor the Thomas cases was there any intention to question the prior decisions of the Court, which allowed priority to claims, etc. . . . against the surplus income arising during the operation of the road."

It is also urged with sôme earnestness that in order to establish a claim of preference, the burden is upon the claimant to show that both parties, and not the claimant alone, understood or intended that payment was to be made out of the current income, and following this statement of the rule is a minute and critical examination of the Stipulation of Facts from which counsel concludes not only that the Railway Company did not intend payment from this source, but

notwithstanding the Agreed Statement to the contrary, it is doubtful if claimants themselves expected payment from the current income. Without going into a tedious analysis of the figures given, it would seem to be sufficient proof that claimants expected payment to be made from the current earnings, that it is so agreed in the Stipulation of Facts, and that it was reasonable to expect payment from that fund appears from the fact, also admitted in the Agreed Statement, that there was at all times until the wrongful diversion thereof, ample money on hand, derived from current income, to pay these claimants, as well as the claims of the two or three others who did not appeal because of the insignificant amounts involved.

But that it is not necessary for claimants to prove both parties intended payment from the current income, appears from the decisions and from the logic of the rule itself. The requirement that the claimant himself must have intended payment from the earnings is but the equivalent of the rule that the sale must have been made upon the personal responsibility or credit of the railway company or upon security.

The Supreme Court decided in

> *Virginia & Alabama Coal Co.* v. *Central R. R. Co.,* 170 U. S., 356,

that it was only necessary as to that matter for it to appear that "it was the expectation of the *creditors* that the indebtedness created would be paid out of

the current earnings of the company." See page 368, where it is said:

> "The dominant feature of the doctrine, as applied in *Burnham* v. *Bowen,* is that where expenditures have been made which were essentially necessary to enable the road to be operated as a continuing business, and *it was the expectation of the creditors that the indebtedness* created would be paid out of the current earnings of the company, a superior equity arises in favor of the materialman as against the mortgage bonds, *in the income* arising both before and after the appointment of a receiver from the operation of the property."

This language was quoted and approved in the *Carnegie* case, 176 U. S., at p. 285. In *Moore* v. *Donahoo,* 217 Fed., at p. 184, the Court said:

> "So with the unsecured claimant: Such equity as he may have flows from the fact that, in the ordinary course of business, he has performed labor or furnished necessary supplies to the railroad company *with the reasonable expectation of being paid therefor from certain funds."*

The reference to "all parties" relates to the implied understanding of the mortgagee that such debts are to be paid before the mortgage.

In *Foster's Federal Practice,* Vol. I, at page 961, it is said:

> "It must appear, however, in all cases, that the *creditor allowed* the debt to be incurred in the belief that it would be paid from the current earnings of the railroad, and that he did not rely solely upon the personal credit of the corporation with whom he made the contract, and *that the debt was one fairly to be regarded as part of the operating expenses of the railroad,* in current receipts,"

Citing:

> *Southern Ry.* v. *Carnegie Co.,* 176 U. S., 290;
> *Lackawanna Ry. Co.* v. *Farmers Loan & Trust Co.,* 176 U. S., 298;
> *Virginia and Alabama Co.* v. *Central Ry. Co.,* 170 U. S., 335;
> *Southern Ry.* v. *Ensign,* 117 Fed., 417.

In the last of these, the *Ensign* case, it is said (p. 421) that among the things necessary in order to give a claim preference over the mortgage lien is, second,

> "*that the person furnishing them* relied upon the interposition and protection of his equity by the court, and did not contract upon the personal responsibility of the railroad company";

We do not at all agree with counsels' construction of the language quoted from the case of *Southern Ry.*

v. *Carnegie,* 176 U. S., 290. The Court said that it appeared from the circumstances of that case that both parties contemplated payment from the current earnings, but it nowhere intimated that it was necessary for it to so appear. On the contrary, the Court said, p. 290:

> "The parties did not in express words declare that the debts due contracted with the Carnegie Company were to be charged upon the current earnings of the railroad company."

and

> "There is nothing in the record to show that the Carnegie Company relied merely or exclusively on the personal credit of the railroad company."

Also, as above stated, the Court, it will be seen on page 285, approved the language of the previous decision in *Burnham* v. *Bowen* and *Virginia Coal Co.* v. *Railway Co.,* that where

> "It was the expectation of the *creditors* that the indebtedness created would be paid out of the current earnings of the company, a superior equity arises, etc."

CHARACTER OF THE MATERIAL AND SUPPLIES FOR WHICH PREFERENCE IS HERE CLAIMED.

In this connection the question which arises is this: Was the material for which appellants claim a preference necessary to the maintenance and operation of the Railway Company's property? We freely admit that there may and often does arise a doubt as to whether material must be considered as intended for construction only, as in the *Lackawanna* case, or whether the same material when taken in relation to the entire system of properties may not be treated as in the nature of maintenance and supply, as in the *Carnegie* case. But we respectfully urge that the question in this appeal is concluded by the Agreed Statements of Facts, and by the testimony of Mr. Markhus, the local manager of the property under the financial direction of the syndicate owning the bonds, who with Mr. Fuller the financial director were the only witnesses in the case. Is it asking too much of the Court to resolve any doubt in accordance with these admitted facts? The agreed Statement is as follows. In the Roebling case:

> "Said material is and was necessary to the continued maintenance and operation of the respective parts of said property for which the same was applied and in which it was used" (Tr., p. 49).

and in the Morris claim:

> "That such machinery is necessary to the continued operation of the Railway Company's *system,* and that without it it could not perform its duties to the public" (Tr., p. 72).

Counsel for appellees (p. 32) charge that the appellants have "seized" upon this sentence to support their contention. It is true, that we rely upon it, but inasmuch as the Stipulations of Facts was agreed upon, after many modifications and careful revision in order to avoid a protracted trial of the issues involved, and as this provision quoted was the most material part of the Stipulation, it is not quite appropriate to charge that counsel has "seized" upon it. It is true also that Judge Dietrich limited its application to the "new parts of the system," but that is the reason we are appealing, because in this we must respectfully urge that the lower Court erred in its construction of the Stipulation. What is true in one case is true in the other, and in the case of the Morris Stipulation it was *agreed* that the machinery was necessary, not to the operation of the "new parts," as said by Judge Dietrich, but it *"is necessary to the continued operation of the Railway Company's system."* It is further admitted, as pointed out in our former brief, that the whole property of the Railway Company, "the indivisible railway system" and "the indivisible power system," of which this material now forms a part, are

interdependent and used in connection with each other; that is, that the *"single indivisible electric street and interurban railway system with properties appurtenant to,"* are *"used in connection with said power and railway properties"* (Tr., p. 100).

It was alleged in the original bill for the appointment of Receiver and admitted in the answer of the Railway Company, as follows:

> "That to segregate either the power properties or the traction properties into their component parts, would be attended with great difficulty and cause great loss and waste, and cause great increase in operating expenses, and diminish the security of the bondholders and general creditors" (Tr. pp. 13 and 22).

If the properties are to be treated as a whole, and, as admitted in the Morris claim, are "necessary to the continued operation of the Railway Company's system," we claim it was error to limit the consideration of the case to the operation of the Gem Transmission Line in the one case and the Swan Falls Power Plant in the other. If these alone constituted the whole system of the Railway Company's property, it may be admitted that the quantity of material supplied was too large to be considered in the nature of supplies; but such is not the rule of law, and such is not the fact, for the Agreed Statement admits that the material and supplies were necessary, not to "construction," but to "the maintenance and operation."

We urge, therefore, that the nature of the material must be considered with relation to the system as a whole. In the *Carnegie* case, a claim for 2500 tons of *steel rails was allowed a preference, because*

> "the quantity was not so large as to preclude the expectation that they could be paid for out of the current earnings of the railroad" (176 U. S., 290).

On the other hand, in the *Lackawanna case,* decided at the same time, a claim for *steel rails was denied a preference* on the ground that the quantity was so large that, relatively speaking, it amounted to reconstruction. If steel rails may be considered to be intended to be for construction in the one case and for supplies in the other, according to its relation to the *entire system,* the same rule may be applied to copper wire or machinery. Here, the amount of the claims is insignificant, when compared with the value of the whole properties of the Railway Company, which are interdependent, and which supply transportation, light and power to the inhabitants of a large portion of southwestern Idaho (Tr., pp. 9 and 22).

To illustrate further: A steel rail supplied to the Southern Pacific for a short branch road out of Los Angeles would not be necessary to the maintenance and operation of the "Shasta Limited," but the claim for preference in such case would not be denied because the rail was necessary only to the operation of the particular branch of the Southern Pacific system of

which it formed a part. It would be treated as in the *Carnegie* case, in relation to the whole property of the railway company. It would scarcely be possible to. imagine a single order of this magnitude which would be necessary to the operation of an entire railway and power system. So we respectfully urge that the construction placed upon this, the most material clause of the Agreed Statement of Facts, is erroneous and is against the decisions and the clear meaning of the Stipulations on which the cases were tried.

This provision in question was inserted, not to show that the material was necessary only to the operation of the Gem Transmission Line or the Swan Falls Plant, but by reason of the fact that a portion of the material was used by the plant of the Idaho-Oregon Company, and as to that material it was necessary for the maintenance and operation of that property to which we will refer later; but to hold that the material was intended for construction purposes only, *when the parties concerned, agreed by their stipulation that it was for maintenance and operation,* or to hold that it was necessary only to the "new parts" alone, when, by a fair construction of the Stipulation, it is agreed that it is *necessary to the "system," would be to hold contrary to the Agreed Statement and to the undisputed evidence.* When the amount of the material is compared with the extent and value of the Company's system, and the amount of earnings actually available, it is reasonable for the parties to

conclude that the claims were properly payable from the current operating income.

As to the property that went into the Idaho-Oregon plant, the Railway Company retained the title. It was covered by the mortgage and, to the extent of its value, added to the security of the bonds. It was necessary to the maintenance and operation of that property, which was in fact managed and controlled by the Railway Company. It was intended that it should be paid from the earnings, which the Railway Company had a right to do because the lien of the mortgage did not attach to the income until the appointment of receiver. For this reason the material furnished under the "Equipment Trust" is included in the claim of preference.

THE AUTHORITIES.

I again call the Court's attention to the distinct holdings of the Supreme Court and the Courts of Appeal upon claims of preference which are not intended to displace the mortgage lien by a charge upon the corpus of the property, but which are based upon *wrongful diversion* of earnings to the benefit of the mortgagee and to the injury of the claimant, thus giving the bondholder not only the benefit of the material itself but also the income intended for its payment. In such cases the rule as to the nature of material is less rigid, and equity inclines to the restoration of that which the mortgage creditor has "inequitably ob-

tained." In addition to this rule, the special equity in this case which we claim should appeal to the Court and which we confess was not as fully presented to the lower Court as in these briefs, is the uncontradicted fact that Mr. Samuel L. Fuller, the head of the syndicate owning the bonds and which received the benefit of the earnings was, at the time of the diversion complained of, the managing director of the Railway Company "with respect to finances" (See opening brief, p. 30, and Tr., pp. 118 and 130, 131).

Reviewing a few of the leading cases which deal with the subject of diversion of earnings as distinguished from the cases cited by appellees, which relate to the displacement of the mortgage lien.

The rule applicable to the case before the Court is nowhere more clearly stated than in

> *Virginia & Alabama Coal Co.* v. *Central R. R. Co.,* 170 U. S., 356.

The opinion written by present Chief Justice White reviews the prior cases, states the equitable rules and approves those given in *Fosdick* v. *Schall.* The principles established seem peculiarly applicable to the facts of this case as recited in the agreed statement. It is said (p. 368):

> "The dominant feature of the doctrine, as applied in *Burnham* v. *Bowen,* is that where expenditures have been made which were essentially

> necessary to enable the road to be operated as a continuing business, and it was *the expectation of the creditors that the indebtedness* created would be paid out of the current earnings of the company, a superior equity arises in favor of the materialman as against the mortgage bonds in the income arising both before and after the appointment of a receiver from the operation of the property."

From the above statement of law it will appear that if, as the stipulation provides, the "said material is and was necessary to the continued maintenance and operation," and it "was the expectation of the creditors that the indebtedness created would be paid out of the current earnings of the company," as the agreement also provides, then the allowance of this claim out of the income or earnings of the company or, if the income has been diverted, then from the corpus of the property, *is not the displacement of the mortgage lien,* but, as stated by Mr. Justice White, is the assertion of *"a superior equity in favor of the materialman as against the mortgage bonds in the income."*

The following extract from the same opinion of Mr. Justice White in the *Virginia Coal Co.* case has direct bearing upon the objections of counsel concerning the portion of the property supplied to the Idaho & Oregon Company under the so-called "Equipment Trust." It is said (p. 369):

> "We conclude from the terms of the contract

> that the intention of the parties was that the coal was to be used in the operation of the lines of the Central Company, and that the mining companies did not rely simply upon the responsibility of the Danville Company, but on the contrary that the coal companies looked to the earnings of the Central system as the source from which the funds to pay for the coal to be furnished was to be derived."

In this case the Roebling Company looked to the earnings of the Idaho Railway Light & Power Company, the defendant herein, for payment for all material supplied. It is so stipulated in the Agreed Statement (p. 2).

In the review found in the above case of *Miltensberger* v. *Logansport Railway,* 106 U. S., 206 (which Mr. Justice McKenna in the *Gregg* case states is the leading case in the Supreme Court on the subject of preferential claims), Mr. Justice White says a preference was allowed over the lien of the mortgage, among other things, "To pay debts incurred for building the *five miles of road and the bridge."* Building five miles of road and a railroad bridge would, under some circumstances, be considered new construction, but the claim in the *Miltensberger* case was allowed a preference because the material was necessary to the maintenance and operation of the road.

The Court in the *Virginia Coal* case also points out that in the *Kneeland* case priority was denied because

"ample provision had been made by the vendor for his security," and because *"there had been no diversion of the current earnings either to the payment of interest or the permanent improvement of the property"* (p. 371).

In the *Gregg* case, which has been referred to as the latest decision of the Supreme Court on this question, Mr. Justice Holmes, speaking for the majority of the Court, says (p. 186):

> *"The case stands as one in which there has been no diversion of income by which the mortgagees have profited, or otherwise."*

And again (p. 187):

> "Cases like *Union Trust Co.* v. *Souther,* 107 U. S., 591; 27 L. ed., 488, 2 Sup. Ct. Rep., 295, where the order appointing the receiver authorized him to pay debts for labor or supplies furnished within six months out of income, *stand on the special theory* which has been developed with regard to income, and afford no authority for a charge on the body of the fund."

Citing

Fosdick v. *Schall,* 99 U. S., 235; 25 L. ed., 339;
Burnham v. *Bowen,* 111 U. S., 776; 28 L. ed., 596; 4 Sup. Ct. Rep., 675;
Morgan's Louisiana & T. R. & S. S. Co. v. *Texas C. R. Co.,* 137 U. S., 171; 34 L. ed., 625; 11 Sup. Ct. Rep., 61;

Virginia & A. Coal Co. v. *Central R. & Bkg. Co.,* 170 U. S., 355; 42 L. ed., 1068; 18 Sup. Ct. Rep., 657;

Southern R. Co. v. *Carnegie Steel Co.,* 176 U. S., 257; 44 L. ed., 458; 20 Sup. Ct. Rep., 347.

It is also said, "it is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the Receiver."

In the *Gregg* case the claim for which preference was denied was for railroad ties supplied, *but which had not been used* when the Receiver was appointed. The Court says:

> "The material point is not the time when they were used but the time when they were acquired."

In

Union Trust Co. v. *Souther,* 107 U. S., 591,

there was a diversion of the income which, the Court says,

> "Instead of being applied in accordance with the order to pay the debts for the supplies and labor, was used with the consent, and it may fairly be inferred, at the request of the bondholders to buy additional grounds, rolling stock, etc.";

and in this connection the Court further said (p. 595):

> "It seems to have been found, in the administration of the cause, that by using the income to add

to the value of the fixed property the interests of all parties would be promoted, and so the fund, which in equity belonged to the labor and supply creditors, was for the time being diverted from them and put into improvements and additions, the proceeds of which are now in court."

In

St. Louis Railway Co. v. *Cleveland Railway Co.*, 125 U. S., 659,

the Court says with respect to the matter of diversion of funds (p. 678):

"On this branch of the case we conclude that the petitioner has failed to establish any diversion and misappropriation of the earnings applicable to the payment of rent of the leased line to entitle him in equity to charge the fund in court for the payment of the arrearage in preference to second and third mortgage bondholders."

Counsel seem to feel it is necessary to distinguish the case of *Fosdick* v. *Schall.* That case is criticised because the Court entered into a full discussion of the equitable rules which should govern the allowance of such claims. The preference was denied, because there had been no diversion of income and the material had not been added to the property or increased the value thereof. In fact it was *not a part of the property upon which foreclosure was sought.* But in the companion case of *Fosdick* v. *Southwestern*

Car Co., 99 U. S., 256, the preference was allowed for cars which added to the value of the property and the security of the bonds and which were included in the decree of foreclosure. As the question was a new one, it is not surprising that the highest court in the land should formulate some equitable rules for guidance in future consideration of such claims for preference. It is true that much was there stated which subsequently found its way into the briefs of preferential claimants in many cases, but this is justified by the fact that substantially every principle announced in the *Fosdick* cases has likewise found its way into the subsequent decisions of the courts, and in this way has become crystallized into a rule of property. Concerning the *Fosdick* cases and the principles there announced and having peculiar application to counsel's contention that we are seeking to displace the lien of a mortgage, the Court in *Union Trust Co.* v. *Souther, supra,* says (p. 595):

> "Clearly, therefore, on the face of the transaction, the *fund in court represents in equity the income which belongs to the labor and supply creditors as well as the mortgage security,* and there was no impropriety in appropriating it as far as necessary to pay the creditors specially provided for when the receiver was appointed. Such a *practice, under proper circumstances, was approved in Fosdick* v. *Schall, ubi supra, and seems to us eminently just.*"

It will also be observed that the principle therein announced that the Court should use the income of the receivership in the same way *that the company would have been bound in equity and good conscience to use it if no change in the possession had been made,* was expressly affirmed in

Burnham v. *Bowen,* 111 U. S., 776.

In *Union Trust Co.* v. *Morrison,* 125 U. S., 591, cited by plaintiff, the Court also says in this connection (p. 612):

> " 'All we then decided and all we now decide is that, if current earnings are used for the benefit of mortgage creditors before current expenses are paid the mortgage security is chargeable in equity with the restoration of the fund which has been thus improperly applied to their use.' It is this remark on which the appellants rely. It is not our intention, however, to decide anything in the present case in conflict with it."

In

Southern Railway Co. v. *Carnegie Steel Co.,* 176 U. S., 257,

as explained in our opening brief, the claim of preference was allowed for rails furnished to the railway company, which ordinarily would constitute material for construction as much as would transmission wire. The Court emphasized the fact that the *amount in-*

volved and the terms of payment indicated that the debt was one fairly to be regarded as part of the operating expenses of the railroad incurred in the ordinary course of business and to be met out of current receipts.

The rule of law applicable in case three has been a diversion of income is also stated in conclusive manner in the *Carnegie Co.* case. It is said that a general unsecured creditor is not entitled to priority over the mortgage *simply* because the material furnished was for preservation of property and the benefit of mortgage security. That, it is said, is no doubt an important element; but (using the language of the Court):

> "Before, however, such a creditor is accorded a preference over mortgage creditors in the distribution of net earnings in the hands of a receiver of a railroad company, it should reasonably appear from all circumstances, including the amount involved and the terms of payment that the debt was one fairly to be regarded as part of the operating expenses of the railroad incurred in the ordinary course of business and to be met out of current receipts."

The Court, after reviewing all previous decisions, makes the following summary of the rules concerning such claims of preference (pp. 284-6):

> " 'In neither the Kneeland nor the Thomas case was there any intention to question the prior de-

cisions of the Court, which allowed priority to claims based upon the furnishing of essential and necessary current supplies, not sold upon mere personal credit, against the surplus income arising during the operation of the road under the direction of a court of equity.'

"It is apparent from an examination of the above cases that the decision in each one depended upon its special facts. This court has uniformly refrained from laying down any rule as absolutely controlling in every case involving the right of unsecured creditors of a corporation, whose property is in the hands of a receiver, to have their demands paid out of net earnings in preference to mortgage creditors. But it may be safely affirmed, upon the authority of former decisions, that a railroad mortgagee when accepting his security impliedly agreed that the current debts of a railroad company contracted in the *ordinary course* of its business shall be paid out of current receipts before he has any claim upon such income; that, within this rule, a debt not contracted upon the personal credit of the company, but to keep the railroad itself in condition to be used with reasonable safety for the transportation of persons and property, and with the expectation of the parties that it was to be met out of the current receipts of the company, may be treated as a current debt; that whether the debt was contracted upon the personal credit of the company, without any reference to its receipts, is to be determined in each case by the amount of the debt, the time and terms of payment, and all other circumstances attending the

transaction; and that when current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with the restoration of any funds thus improperly diverted from their primary use. The doctrine announced in *Burnham* v. *Bowen*—in which case the decisions in prior cases were affirmed—is thus expressed in the recent case of *Virginia & A. Coal Co.* v. *Central R. & Bkg. Co.* above cited: 'The dominant feature of the doctrine as applied in *Burnham* v. *Bowen* is that, where expenditures have been made which were essentially necessary to enable the road to be operated as a continuing business, *and it was the expectation of the creditors* that the indebtedness created would be paid out of the current earnings of the company, a superior equity arises in favor of the materialman as against the mortgage bonds in the income arising both before and after the appointment of a receiver from the operation of the property. The equity thus held to arise when a purchase of necessary current supplies is made by the owning company is not in any wise influenced by the fact that the company itself is the purchaser of the supplies, but is solely dependent upon the fact that the supplies are sold and purchased for use, and that they are used in the operation of the road, that they are essential for such operation, and that the sale was not made simply upon personal credit, but upon the tacit or express understanding that the current earnings would be appropriated for the payment of the debt.' "

In

Porter v. *Pittsburgh Bessemer Steel Co.,* 120 U. S., 649,

the preference was denied for debts for construction work, but there the Court also emphasized the statement *that there had been no diversion of income;* in fact, there had been no income at all. It will be seen by a reference to the brief that when these claims accrued the road of the company had not been open for use. Counsel also quotes from *Wood* v. *Guaranty Trust Co.,* 128 U. S., 416, to show that preference was denied upon a claim for construction work as against the corpus of the property. The following quotation from the opinion, however, has direct application to the question at issue, because it deals with the rule to be followed in case the income has been diverted. The Court says (p. 421):

> "Secondly, it (the argument) overlooks the important fact that the doctrine (of *Fosdick* v. *Schall*) only applies where there is a diversion of the income of a 'going concern' from the purpose to which that income is equitably primarily devoted; viz., the payment of the operating expenses of the concern. In other words, the income must be first devoted to the expenses of producing the income. In this case it is not pretended that the money used in paying the 117 coupons in question was income of the Water Works Company."

THE DECISIONS OF THE CIRCUIT COURT.

Upon analysis of the various decisions of the Circuit Court it will also be found that *the same distinction has been generally observed with regard to claims of preference where based upon a diversion of income to the benefit of the mortgage creditor.* As stated in our former brief, preference has not been denied where such denial would result in allowing the bondholder to retain the value of the material supplied and also the money, in the form of interest, which was intended for its payment. In fact, it will be observed that in most, if not all, the cases in which preference was denied the Court in some part of its opinion is careful to state that there has been no diversion of income.

In *International Trust Co.* v. *Townsend,* 95 Fed., 850, Justice Lurton, expressing the opinion of the Circuit Court of Appeals, said, and we here for convenience quote freely from the text:

> "But, if there has been no diversion of the current income, either before or after the appointment of a receiver, and no 'surplus income' during the receivership, out of which unpaid debts of the income can be paid, upon what theory can the proceeds of a mortgage foreclosure sale be applied to the payment of such debts against the objection of mortgage creditors? If nothing has been diverted from the 'current debt fund,' if there has been no augmentation of the fund applicable primarily to the satisfaction of the mortgage credi-

tors, is there any just or equitable reason for requiring the restoration where nothing has been improperly received? We think in such cases the Court has no power to displace contract rights, and neither *Fosdick* v. *Schall* nor any of the cases which have followed it afford any sufficient authority, when rightly understood, in opposition to this view. These 'debts of the income' are an 'equitable charge' only upon the 'current income' of the mortgaged railroad. If such debts remain unpaid when the railroad passes into possession of a court of equity, this 'equitable charge' is continued, and attached to the 'surplus income' arising under the receivership. If the surplus income is not applied to the payment of the debts to which it is primarily devoted, *but is expended for the benefit of the mortgagee, as in payment of interest, or in the purchase of property which passes under the mortgage, or in betterments of the railroad itself, an equity arises, as a consequence of such diversion, which will justify a court of equity in requiring the mortgagee to restore to the income that which has been taken away. The power of the Court to displace mortgage liens in favor of such unsecured debts of the mortgagor depends upon the fact that the current income, either before or after the receivership, has been diverted to the benefit of the displaced mortgagee, and the extent to which the corpus of the mortgaged property can be called upon to pay such debts of the income is limited by the amount of the diversion."*

The case is not in material conflict with *Rhode Island Works* v. *Continental Trust Co.,* 108 Fed., 5, and is not overruled by the latter case. Upon careful analysis of the two cases there will be found nothing in the *Townsend* case in conflict with the *Rhode Island* case. In fact, the former case is expressly approved. All the elements or conditions prescribed by Judge Lurton are present in this case. See page 7 of opinion in *Rhode Island* case. The demand here presented is not a debt created upon the personal credit of the company but it was the expectation that it would be paid out of current receipts and there was a diversion of net earnings sufficient to pay this demand. The Court further says (p. 8):

> "If the demand of appellant is to be paid at all, it must be paid out of the proceeds of the sale of the mortgaged property of the railroad company at the expense of the mortgagees. But before this can be done it must be made to appear that there *had been* a diversion of current earnings, by which this complainant has been deprived of his equitable rights, and that the mortgagees should equitably restore to the fund liable to the payment of debts of the income the fund thus diverted."

The Court makes it clear that the claimant "took care that there should not be reliance upon the current earnings as a fund to meet the obligation" but had taken security for the claim.

In

Central Trust Co. v. *Colorado Ry. Light & Power Co.,* 200 Fed., 85,

the claim was for repairs upon certain boilers which ordinarily, it must be admitted, would be termed a current expense. But the boilers were new. They had never been used and when erected were not intended for immediate use (see p. 89). There had been no diversion of funds, and therefore no superior equity arose.

The Court said (p. 90):

> "There is nothing alleged nor proven, showing as against the bondholders any equity in claimant, as, for instance, that *during the progress* of the repairs or thereafter there was any diversion of the net income of the plant to such other directions as deprived the claimant of *his equitable rights.*"

In

Niles Tool Works Co. v. *Louisville Ry.,* 112 Fed., 561,

it appears from the syllabus not only that "no diversion of current income was shown" but the property for which preference was claimed "never passed under the mortgage and was not included in the foreclosure decree or sale." From the opinion it appears that there was no surplus income, and that the earnings

were not used or promised in payment, but security was taken.

In

Reyburn v. *Consumers Gas Co.,* 29 Fed., 561,

I think it substantially appears from the opinion that there was no diversion of any earnings derived from operation prior to appointment of receiver and on which creditors could be said to have a "superior equity."

In

Atlantic Trust Co. v. *Woodbridge,* 79 Fed., 39,

the opinion does not show the character of the work done nor what relation it bore to the operation of the plant. The claim for repairs was disallowed *because "there is no allegation of diversion of income, nor indeed, of the receipt of any income."* As to the claim for construction, the complaint, in effect, alleged the services were rendered in the construction of the ditches and canals and such sum was one of the current expenses in the *construction.* It does not seem that such complaint really states a cause of action.

In neither the case of

California Safe Deposit Co. v. *Yakima Inv. Co.,* 82 Fed., 542,

nor the case of

Toledo Ry. v. *Hamilton,* 134 U. S., 296,

on which exclusive authority it is based, was there any diversion of income which would create an equitable lien, nor was there any evidence that the material supplied "was necessary to the maintenance and operation of the road."

In

> *Spencer* v. *Taylor Creek Ditch Co.,* 194 Fed., 635, chiefly relied on by appellees,

there is no discussion of questions of right of priority of claims. The Court merely says (p. 641):

> "We find they do not measure up to the standard required of claims admitted to priority";

that is, *"they would not have been paid by the corporation out of the current income."*

There was no evidence nor admission that the work or material was "necessary to maintenance and operation of plant," and no evidence nor admission that current earnings out of which it would have been paid had been diverted. On the contrary, the Court found that it would not have been paid from current earnings. Such a case upon such facts could scarcely be considered authority for denying preference to a claim in present case in which it is admitted that the material was necessary to maintenance and operation and in which it appears that, as was said in *Virginia Coal Co.* case, it was the expectation of creditors that it was

to be so paid—but the funds intended for such payment were diverted.

In

Rodgers Ballast Car Co. v. *Omaha Ry. Co.*, 154 Fed., 629,

preference was denied on claim for cost of thirty-three ballast cars on the grounds that the magnitude and unusual character of the purchase was such that it could not be assumed it was incurred in the ordinary course of business. The Court says it was "to provide for an unparalleled situation" (p. 633).

In

Bound v. *South Carolina Ry. Co.*, 58 Fed., 473,

preference was disallowed because:

"The debt of the Lackawanna Co. was an ordinary merchandise debt, *evidenced by notes,* which were renewed from time to time."

And because

"The immediate earnings, it is clear, the Lackawanna Co. did not look to as the sale was upon eight months' credit" (page 480).

The Roebling sale was for cash, the Morris sale for short credit, and the company, in each case, looked to the current income for payment (Stipulation of Facts, p. 2).

It will thus appear from a review of all the cases cited by plaintiff's counsel that there is no instance in which preference has been denied upon a claim where all of the equities possessed by these claims were present.

A controlling case from the Circuit Court of Appeals in which the material supplied was analogous in character to the Morris claim, is

Atlantic Trust Co. v. *Dana,* 128 Fed., 209.

The claim was for a *new engine* and the *cost of sinking two wells* upon the property, which the Court found was more in the nature of reconstruction and enlargement of the plant than ordinary repairs. Preference was denied upon the *corpus* of the property, there being no wrongful diversion, *but was allowed upon the income earned prior to the appointment of the receiver* (p. 230). It is there said:

> "It follows that cost of the new engine and additional wells incurred under the order of January 9, 1895, should be charged against the income earned prior to March 18, 1895, when the pledge of income in Trust Company's mortgagee became effective."

It is also said (p. 226):

> "It is the income earned thereafter (the appointment of receiver) and *not that earned theretofore,* that, as against creditors of mortgagor, is thus secured to the mortgagee."

It is held in this case also that a pledge of income does not become effective so long as the mortgagor is permitted to remain in possession of the property and to receive and dispense the earnings.

This case also establishes the doctrine that it makes no difference whether the claim of preference arises upon a debt incurred before the appointment of receiver or afterwards upon an order of the Court (p. 230). The claims of Dana and Whiting were denied because they were for personal injuries which did not enhance the value of the property.

Another instructive case from the Circuit Court of Appeals from the Fifth Circuit is

Clarke v. *Central Railway,* 66 Fed., 803,

in which the following language is used (p. 806):

> "In this case the equities are especially favorable to interveners for it appears that there was a diversion of the income for payment of interest on the bonds."

Reverting to the *Gregg* case and comparing it with this, two distinctions are to be observed. First, the Court states at the outset "that the case stands as one in which there has been no diversion of income by which the mortgagees have profited," and, second, the cross ties which formed the basis of the claim had not been used by the railroad when the receiver was appointed and that it was immaterial that the

receiver had used them afterwards. Justices McKenna, Harlan and White thought the claim should be allowed a preference anyway. There is certainly little doubt but preference would have been allowed if in that case there had been a previous diversion of the funds intended for the payment and material had been previously used upon the property.

THE SO-CALLED SIX MONTHS RULE.

As counsel says, there are some cases which hold that there is a "six months" rule, but on the other hand there are many cases, probably a numerical majority of those cited and particularly from the Supreme Court, which hold that there is not. It is not quite accurate to refer to the decisions of the Supreme Court of the United States which establish a definite rule, as "sporadic instances." It is not disputed by counsel that claims have been allowed which accrued *eight months, eleven months, two years, three years,* and in this Circuit, *twenty-six months,* before the appointment of a receiver (See pp. 33 to 38 of appellants' opening brief). In some cases it is said that the period is "usually six months," but admit that it is not a "fixed rule." In *Farmers Loan & Trust Co.* v. *Kansas City,* 53 Fed., 87, the Court says: "There is no 'six months' rule." In *Railroad Co.* v. *Lamont,* the Court says: "As to such debts there is no arbitrary six months rule as has been often decided."

Decisions from the Ninth Circuit.

There are two decisions from the Ninth Circuit which, when examined closely, are not in conflict, as claimed, viz.:

> *New York Guaranty & Indemnity* v. *Tacoma Ry. Co.,* 83 Fed., 365,

and

> *Spencer* v. *Taylor Creek Ditch Co.,* 194 Fed., 635.

In the first case the preference was *allowed* on a claim for material which the *Court says was purchased more than two years* before the appointment of receiver. Counsel for appellees contend that this time should be reduced to one year, and let that be conceded for the argument. In the *Spencer* case the time was about a year also. In the *Tacoma* case the claim was *allowed,* the Court saying "there is no fixed arbitrary rule," and in the *Spencer* case the claim was *denied,* the Court saying nothing on this point, except to refer to a decision of Justice Harlan, decided nearly ten years before the decision of this Court in the *Tacoma* case, in which Judge Harlan adheres to the six months rule in that particular case, but says:

> "The Court has perhaps not committed itself against applying a different and more liberal rule when the special circumstances or equities of the case demand such course,"

which is equivalent of the language of this Court in the *Tacoma* case, where it is said "there is no fixed or arbitrary rule." If the Court in the *Spencer* case had allowed the claim because claims of that age were entitled to allowance, then there *would have been a fixed and arbitrary rule* that all such claims, if they possessed the other equities required, must be allowed. We do not dispute the power of the courts to deny preference to a claim which is twelve months old, but we also contend that the Court has the power to *allow it,* and where the almost unparalleled equities are present, as in this case, there is certainly sufficient special circumstances to justify the allowance, as practically all the authorities concede may be done. The Roebling claim was about seven months, or, as counsel contend, from nine to seven. The time is fixed from the appointment of receiver, but this, as said by the Court in *Moore* v. *Donahoo,* 217 Fed., 184, is a "circumstance wholly fortuitous" and yet which may be entirely controlling. The Court says:

> "His power to enforce his rights should not be made contingent upon the possibility that the secured creditor may apply to a court for the appointment of receiver or for other equitable relief, a circumstance wholly fortuitous or at least one over which he exercises no control."

In the present case, had the receiver been appointed in November, no question would have arisen about the six months rule, but the application was not

made until December, and as pointed out in our opening brief, the Railway Company, of which the bondholders' manager was the managing director, joined in the prayer for the appointment. As upon examination it is found there is no conflict between the two decisions from this Circuit, it would seem that the question would be settled by the *Tacoma* case, 83 Fed., 365, which discussed the question at length and approved the rule and based its decision upon a series of cases in which claimants were allowed a preference upon claims from 1 to 3 years old and in which the Court stated as follows:

> "A preferential debt is not barred, though contracted more than six months before the appointment of a receiver. As to such debts, there is no arbitrary six-months' rule, as has been often decided."

Judge Harlan in the case cited in the *Spencer* decision says that the reason some period must be fixed is, that "it may be fairly presumed that creditors have ceased to look to current receipts for payment." That doctrine would have little application in this case in the face of the stipulation that the appellants expected payment from the current receipts. It is shown (Tr., p. 120) that the Roeblings refused to accept notes, and (Tr., p. 55) that the Morris were not given or received in payment.

Counsel replied to the argument that a claim 11 months old was allowed in the *Carnegie* case by saying

that the Court referred to what Judge Brewer said in *Blair* v. *St. Louis R. R.,* 22 Fed., 474, decided in 1884, (the same year as *Burnham* v. *Bowen*), that at that time he had no notice of any case exceeding six months, and *"ordinarily* I think this is ample. *Per-" haps in some large concerns, and with extensive " lines of road and a complicated business, a longer " time might be necessary."*

Judge Brewer, as will be observed, here admits that the rule is not inflexible.

It is not to be assumed that the Supreme Court of the United States in the *Carnegie* case would decide that the "six months rule" was absolute, and in the same case allow a claim *eleven* months old. But the Court in that case did not leave the question open. It laid down the rule definitely on the point, which was not a "sporadic instance." The rule there given is at variance with the *Spencer* case, as that case at least is construed by counsel for appellees. The Court decided the question in the following language (see 176 U. S., p. 192):

> *"But no absolute rule on the subject has been prescribed by statute or by judicial decision and a claim accruing six months back of the appointment of receiver may, under the circumstances of particular cases, be accorded the same priority in the distribution of earnings that belongs to like claims arising within that period."*

With this decision, which has not been limited in any way by the Supreme Court, and could not be modified by the Circuits, we submit the question as to the power of the Court to allow preference in a claim which is a month or more outside of the so-called "six months" period. If any special circumstances are needed to invoke equitable relief in such a case, we think they are fully supplied by the record, in regard to the time and the manner of the purchase of the material, the diversion of the earnings, and the appointment of the receiver.

The substance of counsels' reply to our contention that these matters were controlled by the bondholders' syndicate is that while the orders came from New York, the witness Markhus did not know who gave them (p. 98). Our answer is that these matters all related to the Company's finances and, as Mr. Fuller, the manager of the syndicate, was the managing director of the Railway Company *as to finances,* there is but one source from whom the order could have come, with authority. It is not likely that the local manager would have purchased the material at the request of a stranger, or some one having no authority, and while the bondholders may have resided, some in Montana and some in New England, the evidence is that they were organized into a syndicate which owned most or all of the bonds, of which syndicate Mr. Fuller was the manager, and himself and Mr. Chas. H. Sabin, of Guaranty Trust Company, and

Mr. John D. Ryan and others were directors (Tr., pp. 130 and 131).

Neither will the rule of decision be changed because some claimants are rich, and some bondholders are poor, nor from the fact that the property did not sell for the amount of the mortgage. If it had, this question would not have arisen, but a part of the value the bondholders did receive was not only the material supplied by claimants, which it is agreed was worth its cost and increased the security to that extent, but in addition to that they received the earnings from which payment was intended.

Regarding the Morris claim, it is true that the "six months contention" does not arise, for it was admitted in the Statement of Facts "the installation thereof (the machinery) was not finally completed or the work accepted until within six months of the appointment of said Markhus as Receiver" (Tr., pp. 67-68). In a case where there was an agreement to pay before delivery or installation, and the claim was not paid, the period of preference would not begin to run until the work and labor of installation had been completed.

(Over)

FINALLY.

The character of the material. If it be urged that the material was for construction purposes, can the bondholder complain if the Court decides it was material and supplies necessary to maintenance and operation when the parties to the transaction have so agreed?

The diversion of the income. On June 1st, 1913, the Railway Company, which had raised all the money it could, was in this position. It owed these debts for material and supplies for which it had agreed to pay cash. It had on hand sufficient money for this purpose, derived from earnings and intended for such payment, but it could not pay these claims and also the accrued interest on the bonds, and therefore a receivership was inevitable. It had to choose between these obligations and determine which should remain unpaid when the receiver was appointed. The Railway Company was then under the financial direction of the manager of the syndicate owning the bonds, and the bondholder won. Later and a little over six months after the Roebling claim matured, the Railway Company, still under the financial directorate of the syndicate manager, after applying the earnings to the payment of interest, joined in the prayer for the appointment of receiver and "admits that it is " unable to meet and pay its other obligations to its " creditors or to maintain itself as a going concern

" and that it is necessary that a receiver be appointed " to conserve the assets of said defendant and to *pro-* " *tect the interests of its creditors and of the public"* (Tr., p. 22).

This is the basis of appellants' claims for preference.

Respectfully submitted.

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